Attachment B

Predatory Lending in San Jose: A Crisis Demanding Legislative Action

Prepared by Concerned Consumer and Fair Housing Advocates

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I. INTRODUCTION

Predatory loans undermine the American dream of homeownership, the main source of wealth for most Americans. Predatory lenders steal hard-earned equity from working families and destabilize communities in the process. San Jose lost an estimated $113 million to predatory lending in 2001 alone.[1] Since that time, high-cost lending[2] in San Jose has increased, and greater numbers of San Jose residents have sought assistance to stave of abusive brokers and lenders and preserve their homes and financial well being.[3]

Concerned about the alarming increase in predatory mortgage lending in San Jose, community groups last year approached the City Council about enacting an anti-predatory lending ordinance modelled on successful laws from jurisdictions around the country. The draft ordinance would restrict abusive lending practices that lead to stripped equity and foreclosure, while encouraging the continued flow of legitimate credit into San Jose's neighborhoods.

The Council responded, "committing to increased involvement in investigating anti-predatory lending measures"[4] and creating a Stakeholder Group to further consider the problem of predatory lending, the proposed solution of a protective ordinance, and other potential solutions. After a long and informative process, the need for an anti-predatory lending ordinance is even more clear and compelling.

Subprime lending is increasing in San Jose, and is having its largest impact on people of color, immigrants, and elderly residents.[5] Community groups that serve victims of predatory lending

[1] *Stolen Dreams: Predatory Lending in San José*, The Association of Community Organizations for Reform Now, April 2003, p. 2.
[2] High-cost (also known as "subprime") lending is not synonymous with predatory lending, but almost all predatory loans are subprime loans.
[3] This finding is based on testimonials from San Jose homeowners who have received predatory loans, a number of whom in the last year have received legal advice and mortgage counseling referral assistance from The Santa Clara County Fair Mortgage Terms (FMT) Initiative's monthly screening clinic, or are borrowers that San Jose Acorn has identified are victims of abusive loans originated by certain larger financial lenders. Close to one-third of approximately 20 homeowners screened, to date, by the FMT Initiative's volunteer attorneys and mortgage counselors have been monolingual Spanish-speakers, almost all of whom have been issued abusive subprime home purchase loans with first note principal balances well above $250,000. Since August 2003, two FMT Initiative-screened homeowners–elderly, widowed female homeowners–have required legal intervention and mortgage counseling referral assistance in order to combat predatory refinance loans tboth were issued in the last 2 years.
[4] September 12, 2003 Memo from Councilmembers Dave Cortese, Terry Gregory, Cindy Chavez, and Ken Yeager.
[5] See Footnote 3 above.

report an alarming growth in the number of San Jose homeowners seeking assistance.[6] For example, we have seen some indicia of predatory lending—namely, the number of recorded defaults and "cycling" in and out of delinquency—increase among subprime borrowers in areas of San Jose with a high percentage of minority residents.[7] Consumer education and enforcement of existing laws are important measures currently being implemented.

But more is needed. Many of the predatory lending practices in San Jose are not illegal because of gaps in state and federal laws. Certain abusive sales and lending practices are simply not OK and should be prohibited. As other jurisdictions have noted, an ordinance crafted to meet local needs can blunt the impact of predatory practices. At the same time, credible studies have shown that such laws serve to reduce abusive lending while protecting and actually promoting legitimate subprime lending. Accordingly, the San Jose City Council is urged to pass and enforce a well-reasoned ordinance, while encouraging the continuation of other positive measures already occurring in San Jose.

II. RESPONSE TO QUESTIONS POSED BY THE COUNCIL

On September 16, 2003, in directing the Housing Department to organize a Stakeholders Group, the Council raised seven questions for the group to consider. Below, we address these questions.

(h) Where do you draw the line between subprime lending and predatory lending?

There is a profound distinction between legitimate subprime lending and predatory lending. The former should be encouraged, the latter prohibited.

Prime loans are reserved for borrowers with good or excellent credit. All other types of credit can be labeled "subprime." As in all jurisdictions, not all borrowers in San Jose have excellent credit, and therefore there is a need for legitimate subprime lenders to fulfill the credit needs of those borrowers. Responsible subprime loans—those with somewhat higher interest rates due to the slightly greater risk of nonpayment by borrowers with past credit problems—are responsible subprime loan products which fill an important need.

But mounting evidence shows that subprime lending can readily cross the line into predatory lending unless there are proper safeguards in place. "Predatory Lending" has no one definition; we offer the following based on a federal report on the issue. Predatory lending imposes unfair

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[6] Representatives from local Santa Clara County FMT Initiative partner agencies – i.e., legal service providers (Bay Area Legal Aid and Pro Bono Project) and mortgage counseling / first-time homebuyer non-profit counseling agencies (Neighborhood Housing Services of Silicon Valley) – presented to the Stakeholders group and spoke of this increasing problem.

[7] This finding is based on 18 months of default data, which was tracked by legal service providers Fair Housing Law Project and Bay Area Legal Aid, members of the Fair Mortgage Terms Initiative.

and abusive loan terms on borrowers, often through aggressive sales tactics, taking advantage of the borrower's lack of understanding of extremely complicated transactions, and outright deception. Not all subprime loans are abusive, but predatory lending is concentrated in the subprime market.[8]

Available data and review of homeowner loan documents reveal that that there are too many bad subprime loans afflicting San Jose households. These loans, being made unfettered in the City:

- Carry abusive terms or conditions;
- Have rates and fees much higher than can reasonably be justified based on the borrower's credit record;
- Serve primarily to strip equity from the home; and/or
- Are simply unaffordable and designed to fail.

(i) Are there existing problems in San José due to illegal activity? If so, what is the District Attorney doing about it?

There is much illegal lending activity occurring in San Jose that cannot be adequately addressed under existing law and enforcement measures.

There is outright illegal activity taking place, but even much of that is not being addressed. For instance, the Stakeholders Group received a presentation from FAST, the Santa Clara County collaboration of government enforcement agencies organized to address financial abuse.[9] The FAST team impressively fights certain forms of financial abuse occurring in the County. But there are significant limitations to what the FAST program can do to fight predatory mortgage lending.

First, FAST only takes action on behalf of limited classes of people, specifically people aged 65 or older and people aged 18-64 who are dependent adults.

Second, FAST pursues criminal conduct, such as fraud and theft by false pretense. As the DA's office acknowledges, these crimes are generally hard to prove, since they must meet the heightened criminal standard of proof beyond a reasonable doubt.

Third, many victims are not competent enough to contact authorities on their own. Further, many victims of predatory lending feel shame in having lost their homes or equity and in being duped by strangers or even family members. In fact, the DA's office estimates that only 1 in 100 cases are reported.

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[8] *Curbing Predatory Home Mortgage Lending*, United States Departments of Housing and Urban Development and Treasury, June 2000, p. 1-2.
[9] The FAST team consists of Adult Protective Services, law enforcement, the District Attorneys office, Public Guardian, and County Counsel.

Fourth, given the non-violent nature of predatory lending abuses, this is not a priority for law enforcement. The DA and law enforcement do not have the staff to investigate and try all the cases they wish, and must allocate their limited resources.

Finally, and perhaps most importantly, much predatory lending conduct, while clearly unethical, is not currently illegal. Existing laws do not go far enough to protect the consumer due to the industry's massive lobbying power in Sacramento and Washington.

(j) What parts of predatory lending in San José are not currently illegal?

Much of what constitutes predatory lending is San Jose is not currently illegal. A local ordinance is needed to protect San Jose homeowners and homebuyers.

There are many gaps in existing state and federal consumer protections necessitating a local ordinance. Federal law—the Home Ownership and Equity Protection Act (HOEPA)—covers a relatively small number of loans, and its weaknesses have pushed several states and local governments to pass their own more protective legislation.

For instance, California passed an anti-predatory lending law two years ago. The bill, AB 489 (Migden) was the result of compromises. We view the state law as a positive first step that set a floor on consumer protections, since it preserved the right of local governments to pass their own ordinances to protect their inhabitants.

A major weakness of both federal and state law is that they cover too few loans. State law defines some loans as "high cost" based on high interest rate (8 percent above Treasury) and points and fees (6 percent of the loan amount) triggers which only cover 10 to 15 percent of the subprime market, meaning that up to 90% of subprime loans are not subject to the law at all. Many risky high-cost loans are being made in San Jose, but because they do not meet these very high triggers, the affected borrowers receive no additional protection.

Further, the Migden bill only covers mortgages up to $250,000, leaving most San Jose borrowers without its protections. While this limit brings a significant number of loans within its compass statewide (given that the average loan size statewide in 2002 was $233,000), the average home loan size in San Jose in 2002 was $301,000, well over the state-law ceiling.[10]

The federal HOEPA covers an even smaller category of loans than state law. First, it only covers refinance loans, while in San Jose predatory lending has also clearly impacted the home purchase lending market.[11] Further, the annual percentage rate and points and fees triggers are even

[10] 2002 Home Mortgage Data which is reported by lenders covered under the federal Home Mortgage Data Act (HMDA) is one source for this data.
[11] See Footnote 3 above.

higher under federal law than under California law. Thus, federal law does not cover many costly loans.

Further, both federal and state law provide inadequate protections on those few loans they do cover. Specifically, the laws:

- Allow for prepayment penalties which last for at least three years (five years under federal law) and which lock consumers into bad loans because they can't afford to refinance;
- Fail to prohibit "steering," allowing lenders to sell borrowers costlier loans than they should be entitled to given underwriting criteria;
- Permit lenders to "flip" borrowers into successive loans that provide no benefit to the borrower and serve only to generate fees for the lender;
- Leave borrowers vulnerable to "bait-and-switch" tactics at close of escrow without providing for borrower counseling; and
- Leave borrowers with limited English proficiency vulnerable to not even knowing what they're signing.

(k) What problems cannot be dealt with under the FNMA program that was just launched in East Palo Alto, which even includes a fund to rescue victims of predatory lending?

Other jurisdictions' responses to the problem of predatory lending have proven positive, and provide greater support for local ordinances.

The Stakeholders Group received a presentation from an East Palo Alto collaborative working with Fannie Mae to fight predatory lending. The program is an invaluable and vital resource to have in place in any distressed community that is faced with predatory mortgage lending abuses.

Yet the presentation by EPA CanDO highlighted that even a thoughtful counseling and education program, coupled with a rescue refinance loan product through Fannie Mae, cannot substantially blunt predatory practices or rescue many victims of predatory loans. So far, there are challenges posed by this product's underwriting criteria which has resulted in no rescue fund loans being issued. The Fannie Mae program also has very limited enforcement capabilities, as there are few attorneys available to take cases, inadequate laws to protect borrowers who have been targeted by fraudulent practices, and little money to handle the significant financial resources needed to prosecute these cases.

The EPA CanDO Initiative is one four local Anti-Predatory Lending Initiatives in the Bay Area (East Palo Alto, Oakland, San Francisco, Santa Clara County). These initiatives use a holistic service model with the components that are critical to successfully fighting predatory lending.

The components of an effective holistic initiative would include:

- Mortgage counseling and education programs;
- A rescue fund to refinance victims out of bad loans, which requires:
  - Willing lender partners;
  - More flexible underwriting standards; and
  - Creation of additional loan bail out funds or pools to aid severely distressed borrowers.
- Education and outreach campaigns targeted specifically at seniors, non-English speakers, and other vulnerable populations;
- Lenders, brokers and realtors committed to issuing responsible subprime loans;
- Legal and other intervention services for distressed borrowers, including:
  - Private attorneys equipped to take these often complex and challenging cases; and
  - Sufficient staffing and funding for legal service providers;
- Stronger legislation including:
  - Local ordinances responsive to community-specific concerns (e.g., a requirement to provide documents in same language as negotiation; no limit on principal loan amount; lower interest rate & points/fees triggers; and mortgage counseling);
  - Ideally, state & federal laws need to be strengthened, though the prospects for this are slim.

Progress is currently being made on all of these fronts in San Jose, except for the critical piece of a local protective ordinance.

(l) What can we do that won't kill subprime lending?

Enacting and enforcing a reasonable, well conceived anti-predatory lending ordinance will curtail predatory lending while allowing legitimate subprime lending to thrive. Adopting the proposed ordinance and preserving legitimate subprime lending are compatible goals.

The evidence is clear that San Jose can implement measures that provide significantly more protection for consumers than current state and federal law without reducing legitimate subprime lending. The goal of any predatory lending ordinance is to make the marketplace safer for consumers by preserving legitimate subprime lending while forcing out predatory lenders.

Predatory lending law opponents argue against such laws, saying they will force them out of the market and make it harder for those with less than stellar credit records to get a loan. But the evidence does not support this claim. In 2003, the University of North Carolina Business School released its study of the effectiveness of North Carolina's anti-predatory lending law, which was the only such law in existence long enough to review and analyze. That study found that the law significantly reduced harmful refinance loans containing abusive terms; while not limiting access to subprime credit for homebuyers and low-credit-score borrowers.[12] In short, the North Carolina law is working exactly as it was intended, by weeding out predatory loans and allowing legitimate subprime lending to thrive. Note that the North Carolina law is very similar to the proposed San Jose ordinance, and even goes further in some respects.

Another study, this one from Morgan Stanley, found far from dampening the growth of subprime lending, new state and local anti predatory lending laws have *increased* the availability of subprime loans. Lenders believe that improved lending practices that resulted from anti-predatory lending laws have enhanced "consumer comfort levels with subprime products . . . providing a positive impact on loan volume."[13]

Thus, the proposed ordinance will create a win-win situation, where predatory lenders know they are not welcome, and consumers can be more confident that remaining lenders are legitimate and fair providers of credit.

(m) How are other states addressing the regulation issues of the banking business and the industry of loans, as it relates to the city level?

Other states have passed strong laws, or have created a vacuum that must be filled by local ordinances.

As mentioned above, relatively weak federal laws have not kept pace with the prevalence and severity of the predatory lending problem. In response, several states have passed stronger anti-predatory lending laws. Many of these state laws are sufficiently strong to obviate the need for local ordinances. These stronger state laws cover many subprime loans, provide strong protections for covered loans, and hold purchasers of predatory loans liable for the misdeeds of the originating lender. These three notions ensure that consumers have adequate protection.

Yet where state law is insufficient to protect consumers, local ordinances have been considered. Such localities include: Albuquerque, Atlanta, Cleveland, Dayton, DeKalb County, Kansas City, Los Angeles, New York City, Oakland, Philadelphia, Pittsburgh, San Francisco, Sacramento, Toledo, and Washington D.C. These ordinances proposed to:

- Regulate high-cost lending;

[12] Quercia, R.G., Stegman, M.A., and Davis, W.R., *The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment*, Center for Community Capitalism, University of North Carolina, 2003.
[13] Morgan Stanley Equity Research North America Industry Report, July 31, 2002.

- o Link city banking business to lender performance;
- o Provide for education, enforcement, collaboration, alternatives, and a bill of rights; and/or
- o Create alternative loan products to help victimized borrowers.

As noted above, California's anti-predatory lending law provided an incremental improvement in the predatory lending landscape, but preserved the right of local governments to strengthen protections. State law does not cover enough loans, create enough protection for those loans that are covered, or provide victims effective recourse in the majority of cases where loans are sold to others. San Jose should join the ranks of those jurisdictions with adequate safeguards.

(n) Collect statistical data to point out if there is a real problem with predatory lending and if so, what is the severity of it?

Data strongly supports the existence of a predatory lending problem in San José that is harming our community.

There has clearly been a paradigm shift when it comes to mortgage lending. We have gone from an era when the main problem was of the redlining of certain neighborhoods, to today where the reverse redlining that characterizes predatory lending is of greatest concern. Today, almost anyone can get a loan. The question is whether those loans are responsible and fair.

Virtually everyone involved in mortgage lending and homeownership recognizes there is a problem with predatory lending. This includes the bank and mortgage company regulators, government agencies, Fannie Mae and Freddie Mac, community groups, advocates, and most lenders and industry trade groups.[14]

It is hard to quantify the problem of predatory lending. There is no one data source of predatory loans. Victims are afraid and embarrassed to come forward. Litigation on a case-by-case basis is scarce given the resources needed. Existing data sources provide some evidence, but are of limited use because the lending industry continues to fight efforts to require greater reporting of home loan activity. The holders of the most helpful data on predatory lending are the predatory lenders themselves.

The cost of predatory lending is too high to be ignored. For individual homeowners, it can mean economic ruin, stripped equity, and the loss of the most significant asset most families will ever own. For communities, it means boarded-up homes, instability, lower property values, and fewer dollars to support local businesses and infrastructure. According to estimates, annual losses from predatory lending are huge: $9.1 billion

[14] Despite this near unanimity, some lender, broker and realtor members of the SJ Stakeholders Group— disagreed with virtually everyone on national, statewide and local level who has considered the issue of predatory lending— by saying there is no problem in San Jose.

nationwide, $1.8 billion in California,[15] and $113 million in Santa Clara County.[16]

The subprime industry has grown to roughly $200 billion nationally in 2002.[17] Approximately 20 percent of those subprime loans are in California,[18] with the active San Jose market representing a significant portion of that amount.

Nationwide, Freddie Mac has estimated that up to 30 percent of subprime borrowers should be qualifying for "A" loans (the most favorable loans, with substantially lower costs and fees).[19] A survey of over one hundred subprime borrowers in the state found that 33 percent of interviewed borrowers felt that they were victims of predatory lending.[20]

What is particularly disturbing about these figures is that certain vulnerable borrowers are overrepresented in the subprime market. Thus, if abuses are more likely to occur in the subprime market, these abuses are disproportionately impacting minorities, immigrants, and the elderly. One national study identified San Jose as having one of the worst disparities in the nation, with upper-income Latinos 33 percent more likely to get costlier subprime loans than lower-income whites.[21] Another recent study revealed that African American and elderly neighborhoods are receiving more subprime credit than the credit risk of the neighborhood would suggest.[22] A UCLA study found that majority minority neighborhoods in California are the most likely to receive subprime refinance loans.[23] And a study by AARP found (1) a high degree of reliance on mortgage brokers by older borrowers, (2) older borrowers with broker-originated loans were much more likely to report that they did not initiate the contact about the loan, and (3) older borrowers were more likely to report having received loans with less favorable terms.[24]

The difference between a prime and subprime loan can be substantial. In 2002, the average interest rate on a 30-year fixed mortgage was 6.54% and average points paid by the consumer were .6%, according to Freddie Mac. In contrast, in 2002, several subprime lenders originated loans in California with Annual Percentage Rates (APRs)

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[15] *Quantifying the Economic Cost of Predatory Lending*, Coalition for Responsible Lending, October 2001, p. 18.
[16] *Stolen Dreams: Predatory Lending in San José,* The Association of Community Organizations for Reform Now, April 2003, p. 2.
[17] See, e.g., *Predatory Loan Crackdown Won't Ruin the Business; City, State Laws Raise Howls of Protest, But Experience Suggests Limited Impact*, Crain's New York Business, October 21, 2002.
[18] *Quantifying the Economic Cost of Predatory Lending*, pp. 18-19.
[19] *Risk or Race? Racial Disparities and the Subprime Refinance Market*, Center for Community Change, May 2002; *Curbing Predatory Home Mortgage Lending*, p. 105 (noting that 28 percent of subprime borrowers had credit scores that may have qualified them for "A" loans).
[20] *Stolen Wealth: Inequities in California's Subprime Mortgage Market*, California Reinvestment Committee, December 2001.
[21] *Risk or Race?*
[22] *The Broken Credit System: Discrimination and Unequal Access to Affordable Loans by Race & Age*, National Community Reinvestment Coalition, 2003.
[23] *Subprime Refinance Mortgage Lending and Neighborhood Conditions: Evidence from California,* UCLA Advanced Policy Institute, September 30, 2003.
[24] *Older Subprime Refinance Mortgage Borrowers*, Public Policy Institute, AARP, July 2002.

that exceeded 20%, according to state data from the Department of Corporations.[25] SEC documents relating to Asset Backed Securities reveal that loans with interest rates as high as 20% were originated in California, securitized, and sold as investments in 2003.[26]

In San Jose, the numbers and trends are alarming. Legal service and nonprofit counseling agencies report an upsurge in clients with distressed loans, and available data suggests a huge increase in foreclosures in Santa Clara County over the last few years, attributable to a worsening economy and increasing predatory lending practices.[27] The number of homes that went through the formal foreclosure process increased from 59 during the period from November 2000 to October 2001, to 180 foreclosures from November 2001 thru October 2002, to 366 foreclosures from November 2002 thru October 2003.[28] This represents a startling increase of over 500 percent over a three-year period.

The situation promises to only get worse. Subprime lending has been growing, and industry reports show the trend continuing, despite the waning of the refinance boom. As interest rates rise, lenders will no doubt make a concerted push to entice homeowners to refinance. With the increasing prevalence of adjustable rate mortgages over the last few years, more and more borrowers will soon find themselves with growing monthly payments and potential financial trouble. Delinquencies are on the rise, and can only increase as the economy continues to struggle and payments increase.

III. CONCLUSION

The days of redlining certain neighborhoods and borrowers have given way to reverse redlining, where lenders, brokers, and investors make huge profits by targeting high-cost mortgage products to communities ill equipped to defend themselves. We thank the City Council for recognizing the importance of this issue, and urge it to close the gaps left open to predatory lenders by passing the proposed San Jose ordinance. This law represents a reasonable, balanced approach to the issue that studies have shown will reduce predatory lending while allowing responsible subprime lending to thrive.

[25] *Who Really Gets Home Loans, Year 10*, California Reinvestment Coalition, November, 2003.
[26] NOTE: SEC findings cited are from California Reinvestment Coalition research.
[27] See Footnotes 3 and 6 above.
[28] Compiled from information from DataQuick Information Systems.